



South Jersey Gas

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VIA OVERNIGHT DELIVERY
(Also Provided Electronically)
August 2, 2005

Ms. Kristi Izzo
Board Secretary
State of New Jersey
Board of Public Utilities
Two Gateway Center
Newark, New Jersey 07102

Re: Focused Audit of Affiliated Transactions and Management Audit of
South Jersey Gas Company by The Liberty Consulting Group
Docket No. AX04040277
Audit Recommendations with which the Company Respectfully Disagrees

Dear Ms. Izzo:

As requested by Board staff, we are providing you with our comments on the FINAL Focused Audit of Affiliated Transactions and Management Audit ("Audits" or "Report") of South Jersey Gas Company ("SJG" or "the Company"). We are providing you with an original and ten copies for filing with the Board and for inclusion in the FINAL REPORT.

The depth and breadth of these audits on the Company were extensive recognizing that in addition to Affiliate Standards audit items the scope included the Gas Supply function last audited over eight years ago, as well as overall Management and Operations last audited over 12 years ago. SJG commends the entire Liberty Consulting Staff as well as the BPU Staff for their professionalism and support throughout the audit. In fact, the thoroughness of the audits and overall results as described in Liberty's FINAL Audit Report have validated that SJG is in fact a well run company. As noted by Liberty in their Introduction to the Executive Summary, SJG is openly receptive to improvement opportunities and looks forward to working with the BPU to make appropriate changes happen.

Liberty's FINAL Audit Report is segmented into four volumes: Gas Supply; Cost Allocations and Affiliate Relations; EDECA and Affiliate Standards; and, Management and

Operations. Within each volume Liberty has presented their findings, conclusions and recommendations. In total, the report includes 136 recommendations of which SJG accepts a great majority, 118, and agrees to take actions as necessary to implement those accepted recommendations. The Company respectfully disagrees with only three of the recommendations and 15 are accepted in concept with clarifications and/or exceptions.

The remainder of this letter will address SJG's formal responses to the three recommendations with which the Company respectfully disagrees. By separate correspondence, SJG has provided suggested clarifications and/or exceptions to the other 15 recommendations referred to above.

COMMENTS ON RECOMMENDATIONS

Volume ONE: Gas Supply Audit Recommendations

Of the 39 recommendations within this volume of the final audit report, the Company is pleased to agree to implement all recommendations with only three suggested clarifications and/or exceptions addressed by separate correspondence.

Volume TWO: Cost Allocations and Affiliate Relations Audit Recommendations

Of the 12 recommendations within this volume of the final audit report, the Company is pleased to agree to implement all recommendations with only three suggested clarifications and/or exceptions addressed by separate correspondence.

Volume THREE: EDECA and Affiliate Standards Audit Recommendations

Of the 35 recommendations within this volume of the final audit report, the Company respectfully disagrees with only two as discussed below and is pleased to agree to implement the remaining 33 recommendations with no additional suggested clarifications and/or exceptions.

ED-1 Treat SJE energy services, HVAC installations by SJESP, energy product development and plant management and operation by Marina, meter reading services by Millennium and air monitoring services by AirLogics as SJI holding company RCBSs for purposes of applying the standards.

RESPONSE: The Company respectfully disagrees with this recommendation. As all the parties are well aware, SJG has consistently objected to Staff's interpretation of the applicability of the RCBS designation to several of our companies. We believe we have a legally defensible position. The "Affiliate Relations, Fair Competition and Accounting Standards and Related Reporting Requirements" are not clear in several respects as it pertains to the definition of an RCBS. However, this has been an ongoing source of contention for SJG and the Board's Staff.

As to Millennium and AirLogics, SJG still believes that these companies do not comport with the definition of RCBS within EDECA. We do understand the Board and Liberty's concern about those businesses that had their origin as services provided by the utility. We realize that a higher level of scrutiny is necessary and that requirements for open bidding are warranted. Consequently, while not conceding our legal argument regarding the definition of an RCBS, SJG will, as a matter of practice, agree to treat Millennium and AirLogics as within the scope of the RCBS requirements on a going forward basis.

Of great concern to SJI is the recommendation that Marina Energy, LLC be considered an RCBS. N.J.A.C. 14:4-5.1(a) 1 states that the standards of conduct are only applicable to an affiliate of a public utility, which affiliate is "providing or offering competitive services to retail customers in New Jersey." We believe that the products and services that Marina Energy provides are not "competitive" within the meaning of the "Affiliate Relations, Fair Competition and Accounting Standards and Related Reporting Requirements." Furthermore, Marina is not providing services that are "retail" in nature. We believe that the arguments as articulated in the legal opinion letter dated March 19, 2003 from Cozen, O'Connor about Millennium are particularly valid in the case of Marina.

In the case of Marina specifically, several officers including E. J. Graham also hold positions in SJI and SJG. This would not be permitted under the Affiliate Standards. Having the President of SJI/SJG involved in Marina is important not only from a cost efficiency perspective but also from a risk management perspective. He can balance, with direct knowledge, the risk profile of Marina within the framework of SJI's overall risk profile. Based on the preceding, we believe from a legal standpoint and from a business perspective that SJI and the New Jersey Board of Public Utilities (NJBPU) are well served by not applying the RCBS designation to Marina Energy. In the interest of reaching an accommodation with the NJBPU while not conceding our legal argument, SJG respectfully requests that the NJBPU specifically exempt the Company from the requirement of N.J.A.C. 14:4-5.5(q) as it pertains to the sharing of officers with Marina.

ED-2 Cease the practice of deeming retail activities permissible because the BPU has not specifically declared them to be "competitive," and make the change clear to employees through an immediate, supplemental communications program.

RESPONSE: The Company respectfully disagrees with this recommendation. The Company believes it has a well-founded legal right under New Jersey Statutes, and regulations and case law as discussed in Recommendation ED-1 to deem certain activities as outside the scope of the "Affiliate Standards."

Volume FOUR: Management and Operations Audit Recommendations

Of the 50 recommendations within this volume of the final audit report, the Company respectfully disagrees with only one as discussed below and is pleased to agree to implement the

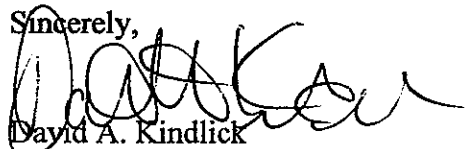
remaining 49 recommendations with only nine suggested clarifications and/or exceptions addressed by separate correspondence.

MO-7 Adopt a lower threshold for the level of business dealings that may be permitted enterprises that board members are associated with, on the one hand, and SJI entities, on the other hand.

RESPONSE: The Company respectfully disagrees with this recommendation. The Company believes that the independence standards set by the New York Stock Exchange are the appropriate measure for establishing thresholds regarding transactions between directors and the Company.

Once again, SJG would like to compliment Liberty Consulting and BPU Staff on the completion of a thorough and extensive series of audits on all aspects of the Company's operations. If you have any questions, please do not hesitate to contact me.

Sincerely,



David A. Kindlick
Executive Vice President and
Chief Financial Officer

Copy: Walter Szymanski, BPU Division of Audits
Nusha Wyner, BPU Division of Energy
Seema Singh, Division of the Ratepayer Advocate
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